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Credit Card Wars Erupt Again

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Although most interest rates have fallen substantially since the early 1980s, those on credit card debt have changed relatively little. This disparity has led to assertions that credit card interest rates are excessive in view of the decline in the funding costs of card issuers. As a result, several pieces of legislation have been introduced in Congress that would impose a nationwide ceiling on credit card interest rates.

Recently, a coalition of the country's largest consumer groups announced the launching of a nationwide campaign to lower credit card interest rates, catching the attention of both bankers and legislators. Ironically, the campaign begins at a time when many banks have already begun voluntarily to lower their rates. Nonetheless, the coalition is encouraging card holders to switch away from high-interest cards, to shop for better prices and services, and to seek legislative remedies in the area of disclosure and rate ceilings. This article focuses on the issues raised by the proposed federal limits on credit card rates, including the harmful effects of such ceilings on the availability of credit card services to different groups of consumers.

Consumer Groups Begin Battle

Consumer groups have stepped up pressure for banks to lower credit card interest rates, pushing for legislation that would impose a national ceiling on those rates. The temptation to impose federal limits stems from the recent U.S. experience with high interest rates. Such measures, however, are inappropriate because prices--in this case, interest rates--generated by the interaction of supply and demand in well-organized competitive markets, merely reflect an optimal adjustment of these forces to perceived economic circumstances, both present and future.

Last year, 22 states considered bills that would cap interest rates and at least seven actually enacted such limits. Usury ceilings were enacted in Connecticut (15 percent on retail and bank cards) and Rhode Island (18 percent), as well as in Iowa, Virginia, Wisconsin, and California. In addition, the Kansas legislature passed a measure banning annual fees and surcharges. Representatives of the consumer coalition insist that the caps encouraged price cutting, citing several banks in Connecticut that dropped their annual interest rates to levels below the ceiling.

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In their efforts to mandate relief for consumers, the proponents of usury ceilings must recognize that the distortions they create with their ceiling may entail costs that exceed those that they are trying to eliminate. Usury ceilings discourage lending and encourage borrowing. And because the demand for credit will now be greater than the available supply at the legal ceiling rate, lenders will ration their credit and naturally favor the most credit worthy customers. The result is that low- and moderate-income individuals and small, risky businesses obtain little or no credit. These persons have no recourse but to go without credit or else obtain it from illegal sources. Credit card interest rate ceilings will thus reverse the trend towards an increased availability of credit in the U.S.

In 1985, a study conducted by the American Bankers Association indicated that states that retained usury ceilings experienced a 17 percent drop in their share of the credit card market, while states that deregulated their ceilings showed a 13 percent gain. In Delaware, for example, laws deregulating credit card interest rates and allowing the establishment of special-purpose banks have attracted 34 new banks, creating over 8,000 new jobs for the state. Similar employment growth has occurred in credit card deregulated states such as Nebraska and South Dakota.

Consumer group representatives also claim that federal limits on interest rates are a step towards preventing lenders from exploiting unsuspecting borrowers. Although this is a legitimate goal, it is not clear that interest rate ceilings do anything to promote it. Consumers and inexperienced borrowers are adequately protected by truth-in-lending laws which require that the terms of credit be stated in clear, understandable language.

The most effective way to prevent exploitation in a market setting is to promote competition among sellers, especially price competition. By contrast, nonprice competition, to which usury ceilings lead, contributes to inefficiency and unfairness. Thus, usury laws in general are counterproductive because they restrict competition and encourage discrimination by lenders.

Are Banks Making an Unreasonable Profit?

Bank profitability is one issue that should be considered in evaluating the effect of any nationwide rate ceiling on credit card plans. Some advocates of credit card rate controls have suggested that profits on credit card plans are large enough to absorb the effects of finance rate restrictions without any substantial adverse impact on either the credit card rate services offered or the prices charged for those services.

According to a recent Functional Cost Analysis by the Federal Reserve Board, between 1972 and 1985, average net earnings before taxes on bank credit card plans were low, both in absolute terms and relative to returns on other major types of bank lending. During that period, the annual net earnings of bank card plans before taxes averaged 1.9 percent of balances outstanding. In comparison, net returns on other major types of commercial

bank lending were higher on average than bank credit card earnings: 2.3 percent on real estate loans, 2.4 percent on consumer installment debt, and 2.8 percent on commercial and other loans.

However, there have been substantial year-to-year variations. For example, the average profitability of bank cards rose to 3.4 percent in 1984 and to 4 percent in 1985 (the peak for the 1972-85 period). In the late 1970s and early 1980s, when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money. Yet, many institutions kept their portfolios despite losses during that period, while other providers sold their portfolios because they were a drain on bank performance.

Recently, favorable economic trends and structural changes in credit card regulation have helped reverse that downward trend. Although funding costs constitute a much lower proportion of total costs for credit card operations than for other major types of bank lending, the sharp decline in market interest rates has contributed to the recent improvement in credit card profits. In addition, the relaxation or removal of regulatory constraints on credit card interest rates in many states in the early 1980s has helped increase profits. These actions were taken after credit card issuers experienced a severe squeeze on profits in the 1979-81 period.

Another factor in the 1984-85 rise in bank card profitability was the major improvement in the quality of issuers' credit card portfolios following the economic disruptions of the late 1970s and early 1980s. Credit card issuers responded to falling profits by adopting much more selective credit standards in an effort to control costs. Also, many credit card accounts were terminated because of delinquencies and payment defaults. Thus, the remaining account holders were relatively good credit risks, causing delinquencies to fall to a historically low level in 1984. Growth in new credit card accounts has now slowed to less than 5 percent a year nationwide, down from a historical growth rate of 15 percent.

Annual data on earnings of retail credit card plans are not readily available. However, two national surveys of retailers were conducted on behalf of the National Retail Merchants Association in 1968 and 1985, and a study of retailers in New York was carried out in 1973. These studies indicate that, on average, such credit card plans consistently operated at a loss. Obviously, tighter credit card rate ceilings would simply exacerbate retailer losses.

Is the Market Competitive?

A critical issue in any discussion of price ceilings is whether the market involved is competitive. The diversity of credit card pricing schemes, the heavy volume of solicitations, and the pace of entry by new competitors seem inconsistent with a general absence of competition. The most notable, Sears, Roebuck and Company's Discover card is one new entrant posing a serious challenge to bank credit cards. Besides the banks, major corporations such as Amoco, J.C. Penny, Subaru, and a joint venture of

Household International and Comp-U-Card, the electronic shopping service, are offering credit cards as are most brokerage firms. And recently, many nonprofit groups have gotten into the act.

With over 15,000 card issuers in the nation, the credit card business is highly competitive. In 1986 there were over 731 million credit cards in the possession of consumers, of which 186 million were bank credit cards. The single largest credit card issuer, Sears, accounted for only 11 percent of all credit card balances outstanding at the end of 1985; the second largest, Citibank, accounted for only 5 percent (see Table 1).

Table 1

Credit Card Credit and Other Consumer Credit
September 1986

	Amount outstanding ($ Billions)	Percent of credit card credit	Percent of consumer credit
All Consumer Credit	584.9	--	100
Credit Card Credit	126.4	100	21.6
Bank card credit	80.6	63.8	13.8
Retail card credit	35.7	28.2	6.1
Other	10.2	8.1	1.7
Bank Credit Card Issuers			
Ten largest issuers	24.7	30.7	4.2
Citibank	6.36	5.0	1.0
Bank of America	4.75	3.8	0.8
Chase Manhattan	2.77	2.2	0.5
Manufacturers Bank	2.58	2.0	0.4
First of Chicago	2.15	1.7	0.4
Chemical Bank	1.61	1.3	0.3
Marine Midland	1.37	1.1	0.2
Wells Fargo	1.30	1.0	0.2
Maryland National	0.89	0.7	0.2
First Atlanta	0.81	0.6	0.1

Sources: Federal Reserve Bulletin, January 1987
The Nilson Report, No. 388 (September 1986) pp. 6-7

The largest 10 card issuers represented only 31 percent of credit card loans. These figures indicate that, even if credit card issuers faced no competition from other suppliers of consumer credit, they would face a high degree of competition from each other--more than enough to resolve concerns about excessive pricing. In such an environment, the marketplace is an accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal.

Credit cards must also compete with other forms of consumer credit from such lenders as finance companies, retailers, manufacturers, and other depository institutions that do not offer credit card plans. In many cases the substitutability of such other forms of credit is direct. For example, one may purchase a stereo system not only with a credit card but also with a loan from a finance company or on direct credit from the retailer. Virtually all consumer products can be purchased on credit, yet only 20 percent of purchasing is, in fact, made on credit card credit. Thus, consumers have ample opportunities for shifting their "debt portfolios" from one category of spending to another in response to different "prices" for different categories of credit.

Competition has forced interest rate charges down. In mid-January, Citicorp cut the rate it charges on its premium cards to 16.8 percent from 19.8 percent. And Manufacturers Hanover Trust cut its interest rate on Visa and MasterCard accounts to 17.8 percent from 19.8 percent. Also, Sears is marketing its Discover card without an annual fee and a rebate of up to one percent on all charges. Other big issuers have begun to offer floating rates (tied to Treasury bills or other financial indices) that are lower than the prevailing fixed rates. If markets were uncompetitive, there would be no incentive for card issuers to cut their rates or eliminate their annual fees. Nor would there be a significant barrier to retailers assessing an annual fee. It is important to recognize that the disclosed rate is not the only element of competition. Focusing on the interest rate overlooks the variety of other services provided by credit cards as well as the variety of pricing systems. Competition is prompting some issuers to offer a diversity of services such as discount bus fares, termite inspections, long distance calls, and vacations.

Credit Cards on the Rise

Despite the high credit card interest rates in many states, consumers are pulling out their plastic more than ever. Since 1980, the combined number of cardholders for Visa and MasterCard has doubled to more than 255 million. According to a survey by Bankcard Holders of America, over 25 percent of cardholders used their cards more frequently in 1985 than in 1984; 40 percent charged items at least once a week; and three out of four paid 18 percent or more on their outstanding monthly balances.

Indeed, credit card debt has expanded rapidly in the last three years--a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high interest rates. Industry experts insist that interest rates are not the determining

factor in consumer acceptance. Most doubt that even the new tax law, which eliminates the deduction for consumer interest and thus makes credit more expensive in after-tax dollars, will have much impact. Essentially, the convenience value of credit cards is so high that people are willing to pay the price. But convenience is not without its costs. In order to provide this unsecured, flexible credit, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems which are unique to this type of consumer credit.

The Cost of Funds

Many have argued that since market interest rates have fallen across the board, then credit card rates should decline by the same magnitude. However, the cost of funds represents only a portion of the total costs of revolving credit. Data from the Functional Cost Analysis show that only 42 percent of the total costs of providing bank card services consists of the cost of funds. Credit processing, debt collection, loan losses, and numerous other administrative costs are an important component of the charge. Because many of these costs vary only slightly with the size of the loan, these costs, which are included in the finance charge, must be proportionally higher for smaller loans.

The Cost of Bad Credit

What is especially worrisome to many bankers and other card issuers is the rising tide of both fraud and personal bankruptcies that is pushing up loan losses on credit card accounts. This year, many bankers are writing off nearly 11 percent of their credit card debt as uncollectible (see Table 2).

Table 2

Credit Quality
(Second Quarter 1986)

	Amount Charged ($ Billions)	Percent Written Off*
Citibank (South Dakota)	8.2	10.8
BankAmerica	5.2	5.7
Wells Fargo	4.0	4.1
Chase Manhattan USA	3.6	10.8
First Chicago	3.3	7.0
Citibank (Nevada)	2.0	4.5
Manufacturers Hanover	1.8	4.8
Citibank (New York)	1.5	1.9
Chemical	1.3	6.0
Marine Midland	1.3	6.6
Security Pacific	1.1	6.2
Maryland National Bank	1.1	3.5
Beneficial National Bank	1.0	10.8

*Annual rate of net charge-offs as uncollectible in second quarter of 1986.

Source: Veribanc, Inc.
Businessweek, November 17, 1986

The depressed economy in the farm belt and problems in the energy sector of the nation are causing losses in regional banks' card loan portfolio. In the year ending September 30, 1986, personal bankruptcies numbered nearly 430,000, up 37 percent compared to a year earlier.

As unsecured lenders, credit card operations recover little or nothing of their outstanding loans in a bankruptcy case. When bankruptcies increase as a percentage of total credit losses, recoveries on these losses decline, and this lowers bank earnings. Although bankruptcies have traditionally accounted for 10 percent of credit card losses at bank card operations, today they represent as much as 40 percent of such losses.

Fraud is also a major problem and losses from it are estimated at $80 million a year according to the American Bankers Association. This represents over one percent of all credit card charges. These losses have encouraged the industry to devote substantial resources to developing a card that is more difficult to alter.

Bank card industry losses since 1970 have fluctuated between 2 percent and 4 percent of credit outstanding. At the end of 1985 they were between 3 and 3.5 percent; and credit card defaults in 1986 are expected to rise to 4.2 percent of charges outstanding.

Thus, bankers argue that taking into consideration fraud losses, coupled with high default rates among charge card users, credit card interest rates are at a level consistent with the costs of supplying such credit to the consumer. Looked at it this way, credit cards are essentially a loan vehicle with very high administrative costs and large fraud and default risks, and the interest rate charged on such unsecured credit must cover these costs.

Economic Effects of Usury Ceilings

Any legislation which would restrict the ability to compete freely would hurt consumers by restricting the availability of a valuable array of services. Faced with a rate ceiling in a competitive market, banks must find some method of offsetting the revenue loss from such a constraint. A likely effect of such a ceiling would be to decrease the supply of credit cards, forcing card issuers to find other ways of reducing costs and raising revenues.

One obvious cost-cutting step that credit card issuers might take is to tighten credit standards so as to reduce the number and the cost of bad debts. As a result, low- and moderate-income borrowers would be denied credit cards as the issuers limited their customers to those that were financially secure. Holders of existing accounts could also be affected by more stringent enforcement of credit limits and by likely increases in minimum payment requirements.

In addition, financial institutions may curtail other services offered with the credit cards. Such features include protection programs that indemnify credit card holders for charges made with lost or stolen

credit cards, rebates on purchases billed to a credit card account and provisions of emergency cash to travelers. If the pressure on profits becomes severe, some institutions may eliminate their credit card plans and retail firms may discontinue in-house plans, with the result that customers would need to rely on a shrinking base of suppliers. Such actions might lead to a concentration of cards in the hands of fewer issuers. Although elimination of credit card operations may seem like an extreme measure, some retailers and financial institutions did discontinue credit card services in the early 1980s in an effort to stem losses.

Another way of offsetting reduced interest income is to shorten or eliminate the grace period that credit card issuers typically allow, and to raise annual fees. In 1985, over 70 percent of commercial banks charged an annual fee for MasterCard and Visa accounts. Charges of this kind would affect all cardholders. Revenues could also be raised if a fee for each transaction were charged by card issuers. As of 1985, only 3 percent of the MasterCard and Visa issuers charged such usage fees. Banks and retailers might also establish or increase fees for processing credit card applications, for replacing lost cards and for issuing monthly statements.

Raising the merchant discounts (the fee banks charge merchants for processing credit card sales) represents still another way of increasing revenues. Increases in merchant discounts will affect both retailers and their customers, including those that do not use credit cards. The lower the volume of business and the lower the average sales ticket, the higher will be the merchant discount.

A final effect of a national usury ceiling on credit card rates would be increased segmentation of credit markets, both by type and geography. A 1981 study by the Credit Research Center observed that interest rate ceilings reduced competition between types of credit as card issuers would tend to specialize in lower credit risks, leaving higher credit risks to a smaller set of emaining sources such as finance companies. In addition, the emergence of numerous national bank cards, especially following the wave of state usury deregulation in the early 1980s, has had a substantial effect in making credit markets more competitive, especially in smaller communities.

The 1981 study also surveyed consumers and creditors in four states with different interest rate ceilings. The findings suggest that effective ceilings on credit card interest rates are more likely to result in reduced availability of bank credit card accounts for low- and middle-income families. The study also provides evidence that product prices might rise if a federally mandated ceiling on credit card rates were adopted. Bank credit card issuers in Arkansas were found to charge retailers merchant discount fees higher than those charged in the states with less restrictive rate ceilings. As with other costs, retailers offset these higher fees by raising product prices. Thus, as expected, cash customers subsidized credit customers. Indeed, major appliances were found to cost about 3 to 8 percent more in Arkansas--nearly 5 percent more on average--than in neighboring states.

Several recent studies show that the supply of bank card credit is, in fact, competitive, that usury ceilings injure consumers by contracting credit availability, and that unregulated credit has grown more rapidly than regulated credit. A 1985 study by Lexicon Incorporated reveals that revolving credit issued by banks in states with no credit card interest rate controls has grown more than twice as fast as credit from banks in states with rate controls. For example, Arkansas (limits credit card rates to 5 percentage points above the Federal Reserve Board's discount rate) was near the bottom for all states--revolving credit issued by Arkansas banks declined in real terms between 1980 and 1985.

Conclusion

The available evidence confirms the predictions of economic theory regarding the adverse effects of interest rate ceilings. The record of credit card profitability since 1972 suggests that restrictive rate ceilings such as those proposed by various consumer groups and legislators would create intense pressures to reduce the supply of credit and lead to inefficient, discriminatory nonprice credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses who are forced to go without credit.